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SUBJECT: FAINT SIGNS OF SPRING, BUT ECONOMIC RECOVERY IN U.K. AT LEAST 12 MONTHS AWAY

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¶1. (SBU) Summary: UK Government officials have been increasingly optimistic in their outlooks for economic recovery. Business Secretary Peter Mandelson, said he sees "green seedlings" in the British economy, while Chancellor Alistair Darling forecast positive growth figures by the end of the year in his 2009 Budget (Reftel). Think-tanks, industry groups and private firms also note glimmers of recovery. "The worst of the recession may well be behind us," said Morgan Stanley economist David Miles, recently designated to join the Bank of England's Monetary Policy Committee in June. Signs of recovery include the easing of credit markets, a slight uptick in consumer spending, and a boost in exports. The UK economy is far from smooth sailing, however, and even optimistic experts predict at least 12 more months of tough times followed by a slow and fragile recovery starting in spring 2010. End summary.

Signs of Stability in Credit Markets

¶2. (SBU) UK monetary policies, including dramatically lower interest rates, the Asset Purchase Scheme and quantitative easing, appear to be making a slow but noticeable impact on credit markets and lender confidence. One indication of this is the three-month London Interbank Offered Rate (LIBOR), which has fallen from almost four percent at the beginning of December 2008 to 1.45 percent. LIBOR is the rate at which banks lend to each other and is also used as a basis to set interest rates for business loans and mortgages. With banks lending to each other at cheaper rates, access to credit for businesses is improving and household credit is expected to follow.

¶3. (U) The Bank of England Growth 2009 Q1 Credit Conditions Survey also highlighted evidence of easing in corporate credit markets, with lenders stating they expected to lend more in the next three months because of cheaper costs of borrowing and greater availability of funds. The survey found overall corporate credit availability as reported by firms had increased in the last three months to mid-March. Major lenders expected the availability of credit to the corporate sector to increase over the next three months. The Confederation of British Industry's (CBI) latest credit conditions survey, published April 20, further showed companies were less negative about the availability of new and existing credit in March than they were in February. Only 36 percent believed the availability of new credit had deteriorated in the past three months, compared with 59 percent in February. Commenting on the survey in the press, Ian McCafferty, CBI's chief economic adviser said, "the view that the pace of deterioration is easing correlates with what businesses are starting to tell us on the ground. Firms are not saying that credit conditions are getting better, but the severity of the disruption is no longer worsening as sharply as it was three months ago. And the combination of easier monetary policy

and the Government's measures to support the banking sector may be starting to have an impact."

¶4. (U) Banks and building societies are also slowly opening their doors to new lending. At its annual shareholder's meeting, Barclays Bank announced plans to increase lending to UK households and businesses by GBP 11bn this year. This is in addition to previous commitments from Northern Rock, Royal Bank of Scotland (RBS) and Lloyds Banking Group to increase lending by a total of GBP 17bn. Of the GBP 17bn, RBS agreed to lend GBP 9bn and Lloyds GBP 3bn as a condition for participating in the Asset Protection Scheme. Northern Rock, nationalized in February 2008, stated it would lend GBP 5bn in 2009 and GBP 9bn in 2010. January to March 2009 figures, however, show gross lending totaled just GBP 33bn, down 52 percent year-on-year.

Consumer Spending and Confidence Up

¶5. (U) Goldman Sachs economists now think the worst is over for UK consumer spending. "Consumers will begin to see some benefits from the recently enacted fiscal package, which should help ease the tight budget constraints imposed by the labor market deterioration," Goldman economists said in a recent report. They also noted an easing in credit markets which had hampered consumption in late ¶2008. Goldman expects consumer spending to begin increasing in the second quarter of 2009 and see economic growth returning in the third quarter.

¶6. (U) Supporting this, March 2009 data from the Office for National Statistics (ONS) also showed a small rise in retail sales volumes, though the ONS attributed this mainly to unseasonably good spring weather. Retail sales volumes in March were 0.3 percent higher than in February when sales fell by 2 percent and they were 1.5 percent higher than a year ago. Clothing, footwear and textile sales grew

8.4 percent year-on-year in March, with the three-month figures showing clothing sales reaching their highest level in more than eight years. Most analysts cautioned, however, that one month was not enough data for a clear trend.

¶7. (U) On April 28, the Conference Board Consumer Research Center also released a report showing its consumer confidence index had increased by much more than economists had expected. Its consumer confidence index jumped to 39.2 in April, up from 26.9 in March. Economists had expected the index to increase to only 29.7. The Center's measure of consumer expectations also surged up to 49.5 from 30.2, suggesting consumers believe the economy is nearing a bottom. The Director of the Consumer Board said, however, "the index still remains well below levels associated with strong economic growth."

UK Exporters Aided By Weak Pound

¶8. (U) A steep depreciation of the British pound sterling of nearly 30 percent since its peak in 2007 is starting to help exporters, according to a manufacturing survey published by the Chartered Institute of Purchasing and Supply. The UK saw a big jump in exports, up 12.8 from January to February, on the back of a weaker pound. This jump triggered a sharp drop in the UK's trade deficit with non-EU countries. The UK's trade deficit with the U.S. shrank by 28.3 percent to its smallest level since November 1999. Improved exports have provided some relief for struggling manufacturers facing reduced domestic demand. The weak sterling is also squeezing imports, which dropped 5.4 percent from January to February, improving the balance of trade and producing a positive contribution to growth. Despite the boost from a weakening currency, UK manufacturing output is declining, falling 13.8 percent in the year to February 2009, but official data indicates the pace of decline has slowed.

Expect a Long Fragile Recovery, Not Green Shoots Growth
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¶9. (SBU) Despite some positive indicators, the UK economy is far from "green shoots" growth. While HM Treasury predicts positive GDP growth of 1.25 percent in 2010, other forecasts are more cautious. The most dismal is the IMF's recent report which predicts the British economy will shrink 4.1 per cent this year and 0.4 percent in 2010 before perhaps emerging from recession in 2011 (Reftel). Moreover, the UK unemployment rate continues a steady climb, hitting 6.7 percent in February - a ten-year high. The Confederation of British Industries expects unemployment will peak at 10.3 percent in the second quarter of 2010. Not surprisingly, areas that have experienced the highest rates of unemployment and biggest jumps in the numbers claiming jobseekers' benefits are traditional manufacturing and heavy industry centers. Newspapers also report recent university graduates are finding it particularly difficult to find jobs. Additionally, the FTSE 100 remains volatile, showing investors are still unsure whether the UK is on the road to recovery. In the Ernst & Young ITEM Club Spring forecast Peter Spencer, chief economic adviser, said: "Although one or two positive signs have started to appear, we face another 12 to 18 months of serious grief." The Council of Mortgage Lenders has also stated that while there are signs of improvement in the housing market, they do not see a trend towards sustained recovery.

¶10. (SBU) Comment: While "green shoots" has become a popular buzz word, most of the positive signs have been based on just a few statistics viewed in isolation from general economic conditions. A more accurate assessment may be that the pace of decline in the UK economy is slowing. The UK's recovery could well take longer if global demand, international trade and global economic growth do not recover as quickly as expected or if additional skeletons come out from the financial sector's closets. While surveys show consumers are gaining confidence, rising unemployment rates and job uncertainty are likely to impact consumer spending and lead to higher savings rates.

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